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PROTECTING THE RETAIL INVESTOR IN AN AGE OF FINANCIAL UNCERTAINTY

Barbara Black[*]

The year 2008 was a devastating one for all investors as the financial meltdown wreaked havoc on the world's economy and left no form of investment unscathed. In October 2007, the Dow Jones Industrial Average reached its all-time high of 14,164.53;[1] by December 31, 2008, it had sunk to 8,776.39.[2] During the year, U.S. investors experienced:

1. the total failure of the big banks to manage their risk, particularly their exposure to mortgage-related securities and other complicated debt obligations;[3]
2. the federal conservatorships of Fannie Mae and Freddie Mac resulting from their foreclosure losses;[4]
3. the collapse of giant insurer AIG because of its losses from credit default swaps ("CDS");[5]
4. the freezing of the auction rate securities ("ARS") market that left thousands of investors holding illiquid investments that had been sold to them on the express representation that they were liquid;[6]
5. the failure of the money market mutual fund, Reserve Primary Fund, to maintain a $1 net asset value for its shares

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* Charles Hartsock Professor of Law and Director, Corporate Law Center, University of Cincinnati College of Law. This article discusses events as of early July 2009. Thanks to Jerrod Kuhn, University of Cincinnati College of Law 2010, for invaluable research assistance.

[1] Dow Jones Interactive Learning Center, DOW Historical Timeline, http://www.djindexes.com/DJIA110/learning-center/ (last visited Oct. 31, 2009).

[2] *Id.* The low for 2008 was 8149 on Dec. 1. *Id.*

[3] For an early analysis of the banks' role in the financial meltdown, see THE PRESIDENT'S WORKING GROUP ON FIN. MKTS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS (Mar. 2008) ("Financial Market Developments Policy Statement"), *available at* http://www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf. The Federal Reserve Board announced in May 2009 that ten of the nation's largest bank holding companies, including Bank of America and Citigroup, remain significantly undercapitalized. *See* BOARD OF GOVERNORS OF THE FED. RESERVE SYS., THE SUPERVISORY CAPITAL ASSESSMENT PROGRAM: OVERVIEW OF RESULTS (May 7, 2009), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20090507a1.pdf.

[4] FED. HOUS. FIN. AGENCY, STATEMENT OF FHFA DIRECTOR JAMES B. LOCKHART 5 (Sept. 7, 2008), *available at* http://www.fhfa.gov/webfiles/23/FHFAStatement9708final.pdf.

[5] The U.S. government currently owns 80% equity interest in AIG. Press Release, U.S. Treasury Dep't, U.S. Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan (Mar. 2, 2009) (available at http://www.treas.gov/press/releases/tg44.htm).

[6] Several large investment firms entered into settlements with the SEC and state regulators over their marketing of ARS. *See, e.g.*, Press Release, SEC, Citigroup Agrees in Principle to Auction Rate Securities Settlement, (Aug. 7, 2008) (available at http://www.sec.gov/news/press/2008/2008-168.htm).

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and its suspension of redemptions;[7] and

6. allegations of market manipulation, false rumors, and naked short selling in the securities markets.[8]

This *annus horribilis* concluded with Bernard Madoff's confession that he ran an old fashioned Ponzi scheme for decades in plain sight of regulators that caused upwards of $50 billion in losses to scores of wealthy investors and charitable foundations.[9]

The impact of these events on the retail investor has been devastating. Forty-seven percent of American households own stocks or bonds, with the growth in stock-ownership rates largely attributable to employees' participation in employer sponsored retirement plans.[10] Workers increasingly bear the risk of market fluctuations in funding their retirements, and those nearing retirement are in grave danger of coming up short.[11] Investors' confidence in the capital markets has been severely undermined. Meanwhile, securities firms are returning to the retail brokerage business, their "bread and butter,"[12] creating the risk that panicked investors will become the victims of future frauds.

The Securities and Exchange Commission ("SEC" or "Agency"), the federal agency with the principal responsibility to protect investors from

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[7] Mary Schapiro, Chairman, SEC, Speech by SEC Chairman: Statement at SEC Open Meeting (June 24, 2009), http://www.sec.gov/news/speech/2009/spch062409mls.htm (proposing reforms to regulation of money market funds).

[8] Press Release, SEC, SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets (Sept. 19, 2008) (available at http://www.sec.gov/news/press/2008/2008-211.htm) (pointing out that the SEC "took temporary emergency action to prohibit short selling" in stocks of financial companies because of concerns about market manipulation); *see also* SEC, 2008 PERFORMANCE AND ACCOUNTABILITY REPORT 10 (2008), *available at* http://www.sec.gov/about/secpar/secpar2008.pdf#sec1 [hereinafter 2008 PAR] (describing SEC's responses to market turmoil).

[9] Diana B. Henriques & Zachery Kouwe, *U.S. Arrests a Top Trader in Vast Fraud*, N.Y. TIMES, Dec. 12, 2008, at A1.

[10] INV. CO. INST. & SEC. INDUS. AND FIN. MKTS. ASS'N, EQUITY AND BOND OWNERSHIP IN AMERICA, 2008, at 3, 5 (2008), *available at* http://www.ici.org/pdf/rpt_08_equity_owners.pdf.

[11] Editorial, *From Here to Retirement*, N.Y. TIMES, Jan. 26, 2009, at A22 (stating that two-thirds of U.S. workers have only 401(k) plans and estimating a $2 trillion cumulative wipe-out of retirement savings so far). Many employers have announced that they will no longer contribute to their employees' retirement accounts. *See* Phyllis Korkki, *Businesses Put Trimmers to Work on Their 401(k)'s*, N.Y. TIMES, June 21, 2009, at BU2. Investment companies marketed target date mutual funds (designed to move investors into more conservative investments as they approach retirement) to older workers; yet, the average loss in thirty-one funds with a 2010 target date was reportedly 25%, and losses varied widely among available 2010 funds. The SEC and Department of Labor held a hearing on June 18, 2009 on target funds. *See* Mary L. Schapiro, Chairman, SEC, Statement at SEC-DOL Hearing on Target Date Funds (June 18, 2009), http://www.sec.gov/news/speech/2009/spch061809mls.htm.

[12] Bank of America acquired Merrill Lynch in something of a shotgun marriage arranged by the Federal Reserve. *See* Matthew Karnitschnig et al., *Bank of America to Buy Merrill*, WALL ST. J., Sep. 15, 2008, at A1 (explaining that the merger would reshape the landscape by "making the nation's prime behemoth even bigger."). On June 1, 2009, Morgan Stanley and Citi announced the closing of their Morgan Stanley Smith Barney joint venture to "create a new global leader in wealth management." Press Release, Morgan Stanley, Morgan Stanley and Citi Launch Joint Venture to Create New Global Leader in Wealth Management (June 1, 2009) (available at http://www.morganstanley.com/about/press/articles/0f9d8d36-4ea4-11de-96f6-3f25a44c9933.html).

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fraud and unfair dealing, prides itself on being "the investor's advocate."[13] Accordingly, an obvious question is why did not the SEC do a better job of protecting retail investors from financial disaster? In this essay I will first set forth some comparisons between other recent financial crises and the 2008 financial meltdown. I will then provide an assessment of the SEC's role during the financial crisis and conclude with a review of key provisions of the Obama Administration's proposed financial regulatory reform package that affect the SEC and investor protection. The Obama proposal offers no redesign of the SEC, relying instead on SEC Chairman Schapiro's commitment to re-energize and recommit the Agency to investor protection. It remains very much to be seen whether these efforts will be sufficient to protect the retail investor from future fraud and to restore her confidence in the markets.

I. THE PAST AND PRESENT

In the past ten years, the U.S. has experienced a disturbing number of financial crises, including the dot-com bubble and its crash,[14] the accounting frauds that brought down some of our largest corporations (e.g., Enron, WorldCom) and one of our largest accounting firms (Arthur Andersen),[15] the "tainted research" scandal that exposed the serious conflicts of interest among sell-side financial analysts,[16] and the market timing and late trading mutual fund scandals.[17] We can make some useful comparisons between these past scandals and the 2008 financial meltdown.

In the earlier scandals, retail investors were often scolded for acting stupidly and greedily. New York City Mayor Michael Bloomberg was quoted as condemning as a "disgrace" the fraudulent accounting, but he went on to say that those who have been buying stocks at multiples that "never made any sense" should also look in the mirror: "*They're as responsible, I think, as those who actually committed the crimes of misstating earnings and fudging the numbers* . . . ."[18] The retail investors suffered more in the earlier scandals than did sophisticated investors. The "smart money," for example, better understood the cheerleading nature of analysts' reports;[19] the market timing and late trading activities were classic examples of the "haves" benefiting at the expense of the "have-nots," for it

[13] The phrase is attributed to William Douglas and is posted on the SEC's website. Mary L. Schapiro, Chairman, SEC, Address to the Council of Institutional Investors (Apr. 6, 2009), http://www.sec.gov/news/speech/2009/spch040609mls.htm.

[14] *See* ROGER LOWENSTEIN, ORIGINS OF THE CRASH: THE GREAT BUBBLE AND ITS UNDOING (2004).

[15] *See* KURT EICHENWALD, CONSPIRACY OF FOOLS (2005).

[16] *See* Barbara Black, *Are Retail Investors Better Off Today?*, 2 BROOK. J. CORP. FIN. & COM. L. 303, 308-09 (2008).

[17] *See id.* at 309-10.

[18] TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 35-36 (2006) (emphasis added) (quoting Michael Bloomberg, Mayor of New York).

[19] Black, *supra* note 16, at 308-09.

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was the "big-ticket" mutual fund purchasers that profited at the expense of the other fund investors.[20]

In contrast, it is acknowledged that the "smart money" caused the current financial meltdown. The origins of the meltdown were (1) bad lending practices in the residential mortgage business, followed by (2) the securitization process[21] that created bad securities that infected all the markets.[22] There was "a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies, and global investors . . . ."[23] These investors were primarily sophisticated investors, and securities law traditionally does not worry so much about disclosure to sophisticated investors because the law expects that they can ask the right questions and conduct their own due diligence. However, we learned that these investors had poor risk management policies and lacked accessible and useful information about the products; in virtually every description of the securitization process, the words "lack of transparency" or "opaque" are used.[24] In addition, these sophisticated investors failed to conduct their own due diligence and instead placed their reliance on credit ratings that had serious flaws in the assessments of the structured finance products.[25] Alan Greenspan, former head of the Federal Reserve and perhaps the strongest advocate for the power of the market to regulate itself, acknowledged that the failures of the risk management systems used by sophisticated investors precipitated the financial meltdown.[26]

Moreover, sophisticated investors have suffered along with the rest of us. The irony of the Madoff scandal is that classic Ponzi schemes are affinity frauds targeted at the least sophisticated individuals in a

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[20] *Id.* at 309-10.

[21] An investment bank buys a pool of mortgages from an originator, organizes a "Special Purpose Vehicle" or SPV, and sells the pool to the SPV. The SPV then issues securities representing fractional interests in the pool, entitled to payments based on the cash flow from the underlying mortgages. For a fuller description, see Richard E. Mendales, Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown and How to Fix It 11 (Dickinson Sch. of Law, Legal Studies Research Paper No. 09-2009, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1354062.

[22] The origins of the meltdown were the deterioration of mortgage origination standards. *The Financial Market Developments Policy Statement*, *supra* note 3, at 1.

[23] *Id.*

[24] *See, e.g.*, U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION, REBUILDING FINANCIAL SUPERVISION AND REGULATION 43 (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf [hereinafter FRR]; Floyd Norris, *A Debacle That Has Wall Street in the Dark*, N. Y. TIMES, Nov. 2, 2007, at C1.

[25] THE PRESIDENT'S WORKING GROUP ON FIN. MKTS, *supra* note 3, at 2.

[26] *The Financial Crisis and the Role of Federal Regulators Before the H. Comm. of Government Oversight and Reform*, 110th Cong. 3 (2008) (testimony by Dr. Alan Greenspan, former Chairman, Federal Reserve Bank), *available at* http://oversight.house.gov/images/stories/documents/20081023100438.pdf; *see also* Harvey L. Pitt, *Learning the Lessons of the Sub-Prime Crisis*, COMPLIANCE WEEK, Oct. 30, 2007, http://www.complianceweek.com/article/3740/learning-the-lessons-of-the-sub-prime-crisis (describing the root cause of the crisis as financial institutions' irrational beliefs and unfounded assumptions).

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community.[27] Madoff's victims, however, included major educational institutions and wealthy investors whom we might have expected to know better.[28]

Finally, after the earlier scandals, the SEC was seen as the solution. Perhaps it should not have been—it did not penetrate the complexities of Enron's SEC filings; it may have turned a blind eye to the market timing and late trading scandals. But, nevertheless, Congress had confidence in the SEC; it gave the Agency extensive rulemaking powers in the Sarbanes Oxley Act of 2002 ("SOX")[29] and, after holding numerous hearings on mutual fund reform, came to believe the Agency would provide better regulation over the mutual fund industry.[30]

This time, many see the SEC as the problem.[31] Before we assess the Agency's recent performance, however, it is important to emphasize that all branches of government must share the blame for the regulatory failures:

- Gramm–Leach–Bliley Act ("GLB"),[32] the 1999 legislation that restructured the financial services industry and removed the restrictions that separated banking, securities, and insurance businesses, did not provide for consolidated supervision over the five large investment company holding companies that did not have a commercial bank (Bear Stearns, Lehman Brothers, Goldman Sachs, Morgan Stanley, and Merrill Lynch).
- Commodities Futures Modernization Act of 2000[33] specifically prohibited the SEC and the Commodity Futures Trading Commission ("CFTC") from regulating CDS and other OTC derivatives; as of September 2008, there was $55 trillion in CDS exposure outstanding.[34]
- Credit rating agencies were largely unregulated until the enactment, in 2006, of the Credit Rating Agency Reform Act ("CRARA"),[35]

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[27] *See generally* Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing "the Reasonable Investor" with "the Least Sophisticated Investor" in Inefficient Markets,* 81 TUL. L. REV. 473, 493 (2006).

[28] *See Madoff's Victims*, WALL ST. J. ONLINE, Mar. 6, 2009, http://s.wsj.net/public/resources/documents/st_madoff_victims_20081215.html.

[29] Sarbanes-Oxley Act of 2002, Pub. L. 107-204, § 3(a), 116 Stat. 745, 749 (codified in sections 11, 15, 18, 28, and 29 U.S.C.).

[30] Black, *supra* note 16, at 320.

[31] *See*, *e.g.*, Joe Nocera, *The Decline and Fall of the S.E.C.*, NYTIMES.COM, Nov. 18, 2008, http://executivesuite.blogs.nytimes.com/2008/11/18/the-decline-and-fall-of-the-sec/.

[32] Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended at 15 U.S.C. §§ 6801-6809 (2000)); *see infra* note 84 and accompanying text.

[33] Commodities Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (codified in scattered sections of 7 U.S.C.).

[34] Christopher Cox, Chairman, SEC, Testimony Concerning the Role of Federal Regulators: Lessons from the Credit Crisis for the Future of Regulation (Oct. 25, 2008), *available at* http://www.sec.gov/news/testimony/2008/ts102308cc.htm.

[35] Credit Rating Agency Reform Act of 2006, Pub. L. 109-291, 120 Stat. 1327.

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even though they were identified as part of the problem in the collapse of Enron and WorldCom where the agencies did not downgrade those corporations' bond ratings to below investment grade until days before they filed for bankruptcy.[36]

- The D.C. Circuit consistently struck down even modest regulatory extension by the SEC.[37]

In short, there was a pervasive deregulatory climate that put its faith in the power of market discipline.

II. ASSESSING THE SEC'S PERFORMANCE

In 2008, the Agency's seventy-fifth anniversary, the reputation of the SEC plummeted, although the nature of the criticisms changed during the year. Initially, advocates of market discipline charged that the Agency's heavy-handed regulation put the U.S. capital markets at a competitive disadvantage. In March 2008, the U.S. Department of Treasury released its *Blueprint for a Modernized Financial Regulatory Structure* ("Blueprint").[38] The genesis of the study was the perception that "U.S. regulatory structure is not optimal for promoting a competitive financial services sector leading the world and supporting continued economic innovation at home and abroad."[39] The Blueprint proposed a reduced role for the SEC. Market stability and prudential financial regulation would be the responsibility of the Federal Reserve, and business conduct regulation and corporate disclosure would be divided between two agencies. In particular, the Blueprint was extremely critical of what it described as the SEC's "rules-based" as opposed to a "principles-based" regulatory approach, and it called for greater reliance on industry self regulation.[40]

With the collapse of Bear Stearns in spring 2008, and again in the fall with the bankruptcy of Lehman Brothers, the criticisms of the Agency focused on its failure to predict or prevent the investment banks' collapse. SEC Chairman Cox acknowledged the inadequacy of the measures of capital and liquidity used by the SEC and blamed the gaps in the regulatory system created by GLB.[41] Increasingly, the SEC was seen as "out-of-the-

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[36] Claire Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 43 (2004).

[37] *See, e.g.*, Goldstein v. SEC, 451 F.3d 873, 883-84 (D.C. Cir. 2006) (holding that SEC's rule requiring registration of hedge fund advisers exceeded its authority); Chamber of Commerce of the U.S. v. SEC, 443 F.3d 890, 909 (D.C. Cir. 2006) (striking down the SEC rule that required mutual funds to have a majority of independent directors).

[38] U.S. DEPT. OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (Mar. 2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf [hereinafter TREASURY BLUEPRINT].

[39] *Id.* at 1.

[40] *Id.* at 11-13, 19-20, 109-13.

[41] *Testimony Concerning the Role of Federal Regulators: Lessons from the Credit Crisis for the Future of Regulation Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 5 (2008)

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loop" and irrelevant to dealing with the financial meltdown.[42]

After the collapse of Bear Stearns, and perhaps to minimize that regulatory failure, SEC Chairman Christopher Cox consistently described the SEC as, first and foremost, a law enforcement agency.[43] The Agency's *2008 Performance and Accountability Report*, issued on November 14, 2008, emphasized the enforcement division's accomplishments: it completed the highest number of enforcement investigations in any year to date, initiated the second-highest number of enforcement actions in Agency history, and set the record, in each of the last two years, for the highest number of corporate penalty cases in its history.[44] In addition, the Agency devoted more than one-third of its staff to the enforcement program, increased the number of enforcement personnel by 4%, and allocated internally its highest amount of funds for enforcement in its history.[45] Then, on December 11, 2008, Bernard Madoff was arrested after he confessed to his two sons, both of whom were senior employees at his firm, Bernard L. Madoff Investment Securities LLC, that he had been running a giant Ponzi scheme for twenty years.[46] He subsequently pled guilty and was sentenced to 150 years in prison.[47]

Thus, at Mary Schapiro's confirmation hearing as new SEC Chair in January 2009, she identified as her priorities "to reinvigorate enforcement"[48] and "to reengage the SEC with the people we serve, namely, investors."[49] Senators repeatedly asked her if she was "up to the task"[50] and "ready and willing to take on [an] . . . incredibly tattered . . . marketplace[.]"[51] Schapiro had to reassure senators that she could be "as aggressive an enforcer as anybody . . . ."[52]

How can we account for the SEC's failures? We will look at three recent events to see what lessons we can learn from them.

(testimony of Christopher Cox, SEC Chairman), *available at* http://oversight.house.gov/images/stories/documents/20081023100525.pdf [hereinafter *Cox Testimony*].

[42] *See, e.g.*, Kara Scannell & Susanne Craig, *SEC Chief Under Fire as Fed Seeks Bigger Wall Street Role*, WALL ST. J., June 23, 2008, at A1; Editorial, *Not Much of a Watchdog*, N.Y. TIMES, Apr. 17, 2008, at A28.

[43] *Cox Testimony*, *supra* note 41.

[44] 2008 PAR, *supra* note 8, at 3.

[45] *Id.*

[46] Henriques & Kouwe, *supra* note 9, at A1, B5.

[47] Diana B. Henriques, *Madoff, Apologizing, Is Given 150 Years*, N.Y. TIMES, June 30, 2009, at A1.

[48] *The Nomination of Mary Schapiro to Head the SEC: Panel I of a Hearing of the S. Banking, Housing and Urban Affairs Comm.,* 111th Cong. 12 (2009) [hereinafter *Confirmation Hearing of Schapiro*].

[49] *Id.* at 13.

[50] *Id.* at 29 (question by Senator Menendez).

[51] *Id.* (question by Senator Menendez).

[52] *Id.* at 30.

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Credit Rating Agencies. The credit rating agencies played an important gatekeeping function in the marketing of mortgage-related securities because many institutional investors are prohibited from purchasing products that do not receive an investment grade rating. The problems with credit rating agencies are well-known: (1) lack of competition—the only significant agencies are Moody's, S&P, and, to a lesser extent, Fitch; (2) conflicts of interest—issuers pay the agencies to rate their securities and frequently pay them for consulting services on "credit enhancement;" and (3) little accountability for poor performance.[53] As the performance of mortgage-related securities deteriorated, the agencies downgraded a significant number of their ratings, thus raising questions about the accuracy of the initial ratings and the integrity of the process as a whole.

In 2007–2008, the SEC conducted an examination of rating agencies' role in the collapse of the subprime mortgage-related securities market. The report found that there was a substantial increase in the number and complexity of the deals since 2002 and a corresponding increase in the revenues derived from rating these products.[54] As a result, staff at the agencies could not keep up with the workload. The SEC staff reported that "[o]ne analyst expressed concern that her firm's model did not capture 'half' of the deal's risk, but that 'it could be structured by cows and we would rate it.'"[55] An email by a rating agency's employee stated: "[T]ensions are high. Just too much work, not enough people, pressure from [the] company . . . ."[56] Another prayed: "Let's hope we are all wealthy and retired by the time this house of cards falters."[57] Rating agencies did not verify the information contained in the loan portfolios presented to them for rating, and they did not insist that the issuers perform due diligence.[58] Their surveillance processes were even "less robust"[59] than the initial ratings process. Critically, while the agencies had policies restricting the analysts from participating in fee discussions with issuers, the report found that analysts were very aware of the fees generated by their ratings.[60]

Despite their importance, and their past problems associated with

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[53] *See generally* Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, 68 Fed. Reg. 35,258 (June 12, 2003); JOHN C. COFFEE, JR., GATEKEEPERS 283-314 (2006); Hill, *supra* note 36, at 43.

[54] SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATION OF SELECT CREDIT RATING AGENCIES 10 (July 2008), *available at* www.sec.gov/news/studies/2008/craexamination070808.pdf.

[55] *Id.* at 12.

[56] *Id.*

[57] *Id.*

[58] *Id.* at 16.

[59] *Id*. at 21.

[60] SEC, *supra* note 54, at 24.

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Enron, credit rating agencies escaped regulation[61] until Congress enacted CRARA,[62] the purpose of which was to "'improve credit ratings quality by fostering competition, accountability, and transparency in the credit rating industry . . . .'"[63] CRARA is a modest piece of legislation that seeks to solve these intractable problems through increased competition and disclosure. An SEC registration process for every Nationally Recognized Statistical Rating Organization ("NRSRO") is supposed to remove barriers to entry,[64] and disclosure about an agency's procedures, methodologies, conflicts of interest, and track record in assessing credit-worthiness is supposed to create more informed consumers of ratings who will shop for quality.[65] However, while CRARA authorizes the SEC to implement reporting and oversight rules (including management of conflicts of interest) with respect to NRSROs, the statute requires that the rules be "narrowly tailored" to meet the Act's requirements.[66] Moreover, CRARA forbids the SEC from regulating "the substance of the credit ratings or the procedures and methodologies"[67] by which the credit agencies determine ratings and expressly does not create private remedies for violations of the reporting requirements.[68]

To date, the SEC has engaged in two rounds of rule-making under CRARA.[69] The second set, adopted in February 2009, specifically addresses concerns about the integrity of the procedures and methodologies used to rate structured finance products.[70] Thus, for example, agencies must disclose whether they rely on information about verification performed on

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[61] SOX § 702(b) directed the SEC to study credit rating agencies. The study, released in January 2003, identified a wide range of issues for further study. *See* SEC, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 1 (2003), *available at* http://www.sec.gov/news/studies/credratingreport0103.pdf. The SEC then issued a concept release in summer 2003 seeking public comment on various issues relating to credit rating agencies, including whether credit ratings should continue to be used for regulatory purposes under the federal securities laws, and, if so, the process of determining whose credit ratings should be used, and the level of oversight to apply to such credit rating agencies. Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, 68 Fed. Reg. at 35,259-61. The industry was able to drag out the legislative process until fall 2006.

[62] Credit Rating Agency Reform Act of 2006, 120 Stat. 1327.

[63] Press Release, SEC, SEC Votes to Adopt Final Rules to Implement the Credit Rating Agency Reform Act of 2006 (May 23, 2007) (available at http://www.sec.gov/news/press/2007/2007-104.htm) (quoting Christopher Cox, SEC Chairman); *see also* S. Rep. No. 109-326, at 1 (2006) [hereinafter Senate Report].

[64] 15 U.S.C. § 78o-7(a) (2006); *see also* Senate Report, *supra* note 63, at 6, 7.

[65] 15 U.S.C. § 78o-7(a)(1)(B)(i-ii), (vi), (a)(3).

[66] 15 U.S.C. § 78o-7(c)(2).

[67] *Id.* The credit rating agency industry has, thus far, been successful in persuading Congress and some courts that credit ratings have First Amendment protections. For a critique of these assertions, see Frank Partnoy, *Financial Gatekeepers: Can They Protect Investors?* (San Diego Legal Studies Paper No. 07-46), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=900257.

[68] 15 U.S.C. § 78o-7(m)(2).

[69] 17 C.F.R. pts. 240, 249b (2008). Adopted in 2007, the first round of rulemaking included rules prescribing the process for a credit rating agency to apply for registration.

[70] Amendments to Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 6,456, 6,456, 6,484 (Feb. 9, 2009) (codified at 17 C.F.R. pts. 240, 249b).

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the assets in determining the rating.[71] Every NRSRO must also make publicly available a random sample of 10% of issuer-paid ratings and their histories for each class of rating for which the agency has issued 500 or more, provided in an XBRL format.[72] The SEC also has outstanding a rule proposal to eliminate use of ratings in the SEC rules promulgated under the Investment Company and Investment Adviser Acts, reflecting its concern that investors have over-relied on credit ratings.[73]

It is too soon to assess the SEC's rulemaking efforts under CRARA, and Chairman Schapiro has indicated that the SEC may issue further rules.[74] Ten NRSROs have registered with the SEC,[75] but to date it appears questionable that the newcomers will provide meaningful competition for the Big Three. The emphasis on disclosure as a panacea seems dubious; because of the complexity of the products, it seems unrealistic to expect that most investors will conduct their own due diligence instead of "over-relying" on ratings. The significance of the limitations on the SEC's authority, moreover, cannot be minimized. To summarize: these are very modest measures indeed to deal with the fundamental problem of agencies' conflicts of interest.

The Collapse of Bear Stearns. The collapse of two Bear Stearns hedge funds in summer 2007 is generally recognized as the beginning of the financial meltdown.[76] After credit agencies dropped ratings on many asset-backed securities, Bear Stearns announced that the two funds were virtually worthless, having lost over 90% of their value.[77] Bear Stearns' forced sale in spring 2008 made clear the fragility of the big banks resulting from the financing of long-term, risky assets with short-term loans, the creation of complex, unregulated products and, most fundamentally, the serious weaknesses in risk management practices at the large financial institutions.[78] After Bear Stearns' collapse, SEC Chairman Cox said that "[f]or the first

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[71] *Id.* at 6,459.

[72] 17 C.F.R. § 240.17g-2(d) (2009).

[73] *See* References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,124, 40,124 (July 11, 2008).

[74] Mary Schapiro, Chairman, SEC, Speech by SEC Chairman: Statement at SEC Roundtable on Credit Rating Agencies (Apr. 15, 2009), http://www.sec.gov/news/speech/2009/spch041509mls.htm; *see also* Re-Proposed Rules for Nationally Recognized Statistical Rating Organizations, 74 Fed. Reg. 6485 (proposed Feb. 2, 2009) (to be codified at 17 C.F.R. pts. 240, 243).

[75] SEC, Credit Rating Agencies—NRSROs,_http://www.sec.gov/answers/nrsro.htm (last visited Oct. 8, 2009).

[76] Allan Sloan, *The Financial Meltdown's Unhappy Anniversary*, FORTUNE MAGAZINE ONLINE, May 15, 2009, http://money.cnn.com/2009/05/15/news/economy/bear.stearns.fortune/.

[77] Gretchen Morgenson, *Bear Stearns Says Battered Hedge Funds Are Worth Little*, N.Y. TIMES, July 18, 2007, at C2.

[78] *See generally* THE PRESIDENT'S WORKING GROUP ON FIN. MKTS, *supra* note 3, at 1; SENIOR SUPERVISORS GROUP, OBSERVATIONS ON RISK MANAGEMENT PRACTICES DURING THE RECENT MARKET TURBULENCE 2 (2008), *available at* http://newyorkfed.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf.

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time, a major investment bank that was well-capitalized and apparently fully liquid experienced a crisis of confidence that denied it . . . financing . . . ."[79] This, however, begs the question: was Bear Stearns well-capitalized?

The SEC regulates net capital requirements for broker-dealers that are intended to protect customers' assets;[80] its regulatory authority does not extend to the holding company or non-broker-dealer entities. In the 1980s, the investment banking firm, Drexel Burnham Lambert, was financially weakened because of the business activities of its non-broker-dealer affiliates.[81] In 1998, Long Term Capital Management, a hedge fund that was run by MIT and Nobel Prize winning economists, collapsed when the "smart money" made stupid mistakes that threatened to bring down the financial system because of the interconnectedness of financial institutions and markets.[82] Thus, the SEC understood that other business affiliates could bring down the broker-dealer firm.[83] Yet GLB, in its restructuring of the financial services industry, left a loophole; there was no consolidated supervision of those five major investment banking firms that did not have a commercial bank. The SEC sought, but Congress did not give it, this authority.[84]

In 2004, those five firms in fact wanted SEC oversight of their consolidated entities, because the European Union ("EU") requires a consolidated regulator for financial services firms.[85] Accordingly, the SEC set up the voluntary Consolidated Supervised Entities ("CSE") Program to provide oversight of the financial and operational condition of the firms at both the holding company and regulated entity level.[86] The CSE Program required the CSEs to maintain and document a system of internal controls; the SEC would approve the controls at the time of application and monitor the controls on an ongoing basis.[87] In addition, the SEC allowed the firms to calculate their net capital requirements on an alternative basis.[88] Its rationale reflects the deregulatory religion of the era: "firms with strong

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[79] *Testimony Concerning Recent Events in the Credit Markets Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 1 (2008) (statement of Christopher Cox, SEC Chairman), *available at* http://banking.senate.gov/public/_files/CoxOpeningStatement.pdf.

[80] *See* 17 C.F.R. § 240.15c3-1 (2009).

[81] *See generally The Issues Surrounding the Collapse of Drexel Burnham Lambert: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs,* 101st Cong. (1990).

[82] *See* Philippe Jorion, Risk Management Lessons from Long-Term Capital Management 1 (June 1999) (unpublished draft, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=169449).

[83] Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 68 Fed. Reg. 62,872, 62,872 (proposed Nov. 6, 2003) (codified at 17 C.F.R. pt. 240) [hereinafter Alternative Net Capital Proposed Rule].

[84] Christopher Cox, SEC Chairman, Address to the Security Traders 12th Annual Washington Conference (May 7, 2008), http://www.sec.gov/news/speech/2008/spch050708cc.htm.

[85] Alternative Net Capital Proposed Rule, *supra* note 83, at 62,874.

[86] Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34,428, 34,428 (June 21, 2004).

[87] *Id.* at 34,428-29.

[88] *Id.*

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internal risk management practices will be able to use mathematical modeling methods already used to manage business risks for regulatory purposes."[89] In this way, the SEC thought it created additional incentives for firms to implement strong risk management practices.

We know now that the CSE Program was a failure.[90] Chairman Cox's explanation for the failure of the program was that it was "voluntary" regulation,[91] but this seems facile, if not misleading. The CSE Program was voluntary in the sense that it was not statutorily required, but the SEC certainly had regulatory clout because, if the firms opted out of the program, they would be required to comply with the EU regulation that they sought to avoid. In fall 2008, the SEC's Office of Inspector General issued a report sharply critical of both the design and the SEC's oversight of the CSE Program.[92] In particular, it found that the SEC staff became aware of numerous "red flags" that should have tipped it off to Bear Stearns' shortcomings in risk management and overconcentration in mortgage securities that led to its liquidity crisis. This suggests that the CSE Program failed because the agency lacked the manpower and expertise to provide adequate oversight.[93]

In fact, the initial premise of the CSE Program—that the firms' business practices and the regulators' concerns could coincide—was faulty, and the Agency's reliance on market discipline was simply naive. In fall 2008, the only two surviving banks that were in the CSE Program became bank holding companies under the oversight of the Federal Reserve.[94] As a result of the CSE Program, there is general agreement that there is no role for the SEC in monitoring systemic risk.

The Madoff Scandal. In sharp contrast to credit rating agencies and the five investment banks previously in the CSE Program, the regulation of

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[89] *Id.* at 34,428.

[90] Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008) (available at http://www.sec.gov/news/press/2008/2008-230.htm) [hereinafter End of CSE Program Release]; H. DAVID KOTZ, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM, REPORT NO. 446-A at viii (Sept. 25, 2008), *available at* http:// www.sec-oig.gov/Reports/AuditsInspections/2008/446-a.pdf [hereinafter SEC INSPECTOR GENERAL CSE PROGRAM REPORT].

[91] End of CSE Program Release, *supra* note 90.

[92] SEC INSPECTOR GENERAL CSE PROGRAM REPORT, *supra* note 90, at viii-xi. The SEC Inspector General also was critical of the agency's performance in its Broker-Dealer Risk Assessment Program that tracks 146 broker-dealers that are part of a holding company structure and have at least $120 million in capital. *See* H. DAVID KOTZ, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: BROKER-DEALER RISK ASSESSMENT PROGRAM, REPORT NO. 446-B at v (Sept. 25, 2008), *available at* www.sec-oig.gov/Reports/AuditsInspections/2008/446-b.pdf.

[93] Professors Coffee and Sale's conclusion—that the SEC was "outgunned" by the banks—is consistent with this. John C. Coffee & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 742 (2009).

[94] Andrew Ross Sorkin & Vikas Bajaj, *Shift for Goldman and Morgan Marks the End of an Era,* N.Y. Times, Sept. 21, 2008, at A1.

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broker-dealers and investment advisers is central to the SEC's power and mission; there was no regulatory gap. Thus, the Madoff scandal[95] presents the most troubling question that the SEC must grapple with: how could Bernard Madoff conduct his Ponzi scheme for two decades in plain sight of the regulators—not just the SEC, but also NASD/FINRA, the self-regulatory organization with primary responsibility for regulating broker-dealer firms?[96]

Immediately after Madoff was arrested, the SEC acknowledged that "credible and specific allegations regarding Mr. Madoff's financial wrongdoing, going back at least until 1999, were repeatedly brought to the attention of SEC staff."[97] A derivatives expert and trader, Harry Markopolos, repeatedly made detailed submissions to the SEC's Boston office, who referred the matter to the New York branch. In his November 7, 2005, nineteen-page submission, Markopolos set forth an analysis of performance data to back up his assertion that Madoff's trading strategy could not work and that it was "[h]ighly likely" that Madoff Securities was the world's largest Ponzi scheme.[98] At least after the third submission, the SEC's New York office conducted an investigation. The staff, relying on voluntary production of documents and testimony, found no evidence of fraud, but did find that Madoff acted as an unregistered investment adviser. It closed the investigation after Madoff registered with the SEC as an investment adviser because it concluded that "those violations were not so serious as to warrant an enforcement action."[99] As recently as spring 2008, Markopolos again submitted his analysis to the SEC, this time to the D.C. office, and received no reply.[100]

How could this happen? Unfortunately, while there are many possible explanations, they cannot explain the enormity of the Agency's failure. The SEC staff may have lacked the expertise to understand the improbability of Madoff's trading strategy.[101] They may have been

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[95] For a brief narrative of the salient facts, see Amir Efrati et al., *Top Broker Accused of $50 Billion Fraud*, WALL ST. J., Dec. 12, 2008, at A1.

[96] Kara Scannell, *Madoff Chasers Dug for Years, to No Avail*, WALL ST. J., Jan. 5, 2009, at C1 (noting that the SEC and other regulators examined Madoff or his firm "at least eight times in sixteen years").

[97] Press Release, SEC, Statement Regarding Madoff Investigation (Dec. 16, 2008) (available at http://www.sec.gov/news/press/2008/2008-297.htm) [hereinafter SEC Madoff Statement].

[98] Gregory Zuckerman & Kara Scannell, *Madoff Misled SEC in '06, Got Off*, WALL ST. J., Dec. 18, 2008, at A1; Harry Markopolos, The World's Largest Hedge Fund Is a Fraud 2 (2005), *available at* http://static.reuters.com/resources/media/editorial/20090127/Markopolos_Memo_SEC.pdf.

[99] SEC DIV. OF ENFORCEMENT, CASE CLOSING RECOMMENDATION, CASE NO. NY–07563 (Nov. 21, 2007), *available at* http://online.wsj.com/public/resources/documents/Madoff_SECRecommend_20081217.pdf.

[100] Zuckerman, *supra* note 98.

[101] This is Markopolos' primary explanation; the SEC is an agency with too many lawyers, and not enough industry people on staff. *Rep. Paul E. Kanjorski Holds a Hearing on Regulatory Failures Before the H. Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises*, 111th Cong. 4, 19, 34, 50 (2009) (testimony of Harry Markopolos, CFA, CFE), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/markopolos020409.pdf [hereinafter *Markopolos Testimony*].

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"dazzled" by Madoff's reputation; he was one of the Wall Street legends and a former chair of NASDAQ who had served on influential SEC advisory groups.[102] "Industry capture"—attendance at industry sponsored meetings and conferences and post-SEC job opportunities—may have played a part as well.[103] Insufficient funding is a perennial difficulty that is unlikely ever to go away;[104] scarce resources require setting priorities; and the SEC staff may have thought that since Madoff's clients were sophisticated investors, they could look out for themselves.[105] Some critics have suggested that the pressure to resolve enforcement actions quickly may cause SEC staff to go after the "small fish" or uncomplicated cases.[106] SEC Chairman Cox identified systemic problems as a possible cause and noted that the allegations never reached the level of the Commission; failure to seek a formal order of investigation meant the staff did not have subpoena power.[107] Was this a staff error, or does it suggest a problem with the tone at the top? Did the staff feel "handcuffed" by the Commissioners? While some recent Commissioners have been skeptical of, if not hostile toward, enforcement,[108] the duration of the fraud and the Agency's failure to detect it for so many years, mean that the deregulatory Bush-era environment cannot be the sole cause. Others have focused on the relationship between the enforcement division and the office of inspections and examinations and have suggested that the 1994 separation of inspections and examinations from the enforcement division meant that the latter had less real-time "on the ground" information.[109] Finally, there is the problem of how to separate

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[102] Chairman Cox specifically asked the SEC's Office of Inspector General ("OIG") to investigate staff contacts and relationships with Madoff and his firm and any impact they may have had on staff decisions. *Assessing the Madoff Ponzi and the Need for Regulatory Reform: Hearing Before the H. Comm. on Financial Serv.,* 110th Cong. 6 (2009) (statement of H. David Kotz, Inspector General of the SEC), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/kotz010509.pdf [hereinafter *OIG Testimony*]. One of the criticisms of the SEC staff over the years has been that they go after big names (e.g., Martha Stewart, Mark Cuban) for personal glory and professional advantage. Perhaps the considerations are different when the person is in the securities industry.

[103] But staff cannot acquire expertise in a vacuum. *See supra* note 101 and accompanying text.

[104] The SEC attributed a decrease in the examinations of mutual funds and investment advisers in part to decreased funding. SEC, FY 2008 PERFORMANCE BUDGET 137 (2007), *available at* http://www.sec.gov/about/2008budgetperform.pdf.; *see also*, Press Release, SEC, Statement from Chairman Schapiro on Proposed Budget for SEC (Feb. 26, 2009) (available at http://www.sec.gov/news/press/2009/2009-37.htm) (noting that "the President's FY 2010 budget request for the SEC . . . represents a 13 percent increase over its FY 2008 budget").

[105] According to the *Washington Post*, in 2004, an SEC attorney noted discrepancies in information provided by Madoff, but was instructed by her supervisors to focus instead on mutual fund investigations because of the publicity generated by revelations of the market-timing activities. Zachary A. Goldfarb, *Staffer at SEC Had Warned of Madoff,* WASH. POST, July 2, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/07/01/AR2009070104223.html.

[106] Joe Nocera, *S.E.C. Chased Small Fry While Big Fish, Madoff, Swam Free*, N.Y. TIMES, June 27, 2009, at B1.

[107] SEC Madoff Statement, *supra* note 97.

[108] Paul S. Atkins, who was an SEC Commissioner from 2002–2008, was particularly vocal in his criticism of enforcement. *See, e.g.*, Paul S. Atkins, Remarks Before the Exchequer Club of Washington, D.C. (July 16, 2008), *available at* http://www.sec.gov/news/speech/2008/spch071608psa.htm) (calling for an independent advisory panel to evaluate the enforcement program).

[109] The OIG is conducting an official investigation. *See OIG Testimony*, *supra* note 102, at 2.

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wheat from chaff—the SEC gets lots of tips, frequently from competitors of the alleged wrongdoer.[110] Nevertheless, whatever its causes, the Madoff scandal will be remembered as one of the greatest stains on the SEC's reputation.

III. FINANCIAL REGULATORY REFORM AND THE FUTURE OF THE SEC

In June 2009, the Department of Treasury released the Obama Administration's package of proposed reforms, *Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation* ("FRR").[111] The visionary title and the document's length (eighty-eight pages) are misleading; given the enormity of the problems, the proposed reforms are modest, and as of the writing of the essay, it is not possible to predict the likelihood of success of even these modest measures.

The 2008 financial meltdown demonstrated the interconnectedness of firms and markets; hence, a consensus has emerged that the most pressing reform measure is systemic risk monitoring. As expected, the Administration proposes that the Federal Reserve will act as the systemic risk regulator,[112] with some vaguely defined role for a Financial Services Oversight Council that will replace the shadowy President's Working Group on Financial Markets.[113] The Fed will formally become what pragmatically it already is, the consolidated regulator for all banks.[114]

The second important reform advanced in the FRR is better consumer protection with respect to credit instruments and the recognition that the marketing of complicated financial products with poorly disclosed or even disguised onerous terms does not serve consumers well. However, the banking industry already is mounting a concerted effort to defeat the

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[110] Since their appointments, both SEC Chairman Schapiro and Director of Enforcement Khuzami have spoken frequently on reinvigorating the enforcement division and improving the review of tips. *See Testimony Before the H. Subcomm. on Financial Serv. and General Government,* 111th Cong. 1-2 (2009) (statement of Mary Shapiro, SEC Chairman), *available at* http://www.sec.gov/news/testimony/2009/ts031109mls.htm; *Strengthening the SEC's Vital Enforcement Responsibilities: Hearing Before the S. Banking, Housing, and Urban Affairs Subcomm. on Securities, Insurance, and Investment*, 111th Cong. 5-10 (2009) (statement of Robert Khuzami, Director, Division of Enforcement of the SEC), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=e939892e-0d06-4da7-9ddf-52a2def98458.

[111] FRR, *supra* note 24.

[112] *Id.* at 20. The recent congressional grilling of Benjamin Bernanke over the Bank of America–Merrill Lynch merger suggests some legislative opposition to the Federal Reserve's expanded powers. Edmund L. Andrews & Louise Story, *G.O.P. to Paint Bernanke as Big Government Ally*, N.Y. TIMES, June 25, 2009, at B1.

[113] The President's Working Group on Financial Markets was created by Executive Order after the October 1987 market crash; its members include the Treasury Secretary and the Chairmen of the Federal Reserve Board, SEC, and CFTC. *See* Exec. Order No. 12,631, 53 Fed. Reg. 9,421 (March 18, 1988). Little is known about its actual workings. *See* Simon Dumenco, *Saved by the Cabal!*, N.Y. MAG., Jan. 27, 2008, http://nymag.com/news/intelligencer/43342/.

[114] FRR, *supra* note 24, at 12, 36.

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Consumer Financial Protection Agency,[115] the proposal's boldest pro-consumer initiative;[116] the battle over this proposed agency will be an important test of the Administration's commitment to consumer protection.

Focusing specifically on the SEC, given its failings, the Agency emerges relatively unscathed. As with previous financial scandals,[117] the Administration has chosen to view the Agency's missteps as resulting from insufficient resources and lack of leadership, perhaps because it does not wish to expend political capital on structural reforms. Thus, the SEC is expected to receive some additional funding and some new staff positions, principally in the examination[118] and enforcement[119] programs. SEC Chairman Schapiro has apparently persuaded the Administration that she is indeed "up to the task,"[120] and she quickly recruited from outside the agency an experienced prosecutor to head up the enforcement division.[121] As a result, apart from losing oversight over investment banks (a role it had already abandoned), the SEC has not lost any power and will not have to undergo restructuring. Although the FRR calls for closing the loophole that left OTC derivatives unregulated and for "comprehensive" regulation of OTC derivatives,[122] it does not call for a merger of the CFTC and SEC, although their turf wars have been a significant distraction over the years. Instead, the FRR directs the agencies to work together to harmonize futures and securities regulation.[123] Similarly, although initial press reports suggested that the new consumer protection agency would take over the regulation of mutual funds, in recognition of the importance of this investment vehicle to retail investors,[124] the SEC will retain that authority, despite its past poor performance. The SEC will gain modest expansion of powers in some areas; for example, hedge fund advisers will be required to register with the SEC.[125] Otherwise, it is more of the same for the SEC, with an expectation that it will perform better. Thus, there are vague

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[115] This new agency would assume responsibility for protecting consumers in the financial products and services markets, except for products and services already regulated by the SEC or CFTC. *Id.* at 55.

[116] Edmund L. Andrews, *Banks Balk at Agency Meant to Aid Consumers*, N.Y. TIMES, July, 1 2009, at B1.

[117] *See supra* notes 29-30 and accompanying text.

[118] SEC, FY 2010 CONGRESSIONAL JUSTIFICATION IN BRIEF 7-8 (2009), *available at* http://www.sec.gov/about/secfy10congbudgjust.pdf.; *see also id.* at 10 (devoting additional resources to assessing how investment advisers and broker-dealers verify existence and maintain control and custody of customers' assets).

[119] *Id.* at 13 (stating that the highest priority is to respond to the current financial crisis).

[120] *See supra* note 50 and accompanying text.

[121] Press Release, SEC, Robert Khuzami Named SEC Director of Enforcement (Feb. 19, 2009) (available at http://www.sec.gov/news/press/2009/2009-31.htm).

[122] FRR, *supra* note 24, at 46.

[123] FRR, *supra* note 24, at 49-50. Since the CFTC's creation, the agencies have dueled over this issue. In recognition of turf warfare, the FRR expects the new Financial Services Oversight Council to mediate disputes. *Id.* at 51.

[124] Zachary A. Goldfarb et al., *U.S. May Add New Financial Watchdog*, WASH. POST, May 20, 2009, at A01, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/05/19/AR2009051903061_pf.html.

[125] FRR, *supra* note 24, at 12, 37.

references to "expanded" authority to mandate more disclosure,[126] additional regulation of credit rating agencies[127] (with no recognition of a need for more statutory authority to cure the statute's limitations[128]), and harmonization of investment adviser and broker-dealer regulation.[129] Some of the investor protection proposals sound frankly like window dressing, *e.g.*, the creation of a Financial Consumer Coordinating Council to address gaps in investor and consumer protection[130] and additional studies on the much debated issue of the fairness of mandatory arbitration in consumer[131] and securities disputes.[132]

More generally, what lessons can we learn from the recent regulatory failures? First, we must get rid of the "hands off" attitude toward institutional and sophisticated investors that is ingrained into the regulatory climate. For too long, policymakers have thought that some investors are so smart that regulators should not stand in their way, for fear of stifling innovation and investment opportunities. We have learned, once again, that the "smart money" is not so smart, and, more importantly, their errors are colossal ones that impact every aspect of the economy and harm all of us.

Second, voluntary regulation does not work, as Chairman Cox came to recognize.[133] Market discipline does not work, as Alan Greenspan learned.[134] Industry self-regulation, while a practical necessity, has serious limitations.[135] Investors' advocates must guard vigilantly against warnings about the dangers of over-regulation that we are already hearing. In fact, I submit that we need never worry about over- regulation; business interests have many well-funded and effective lobbyists, including the securities and accounting industries, small business, and the U.S. Chamber of Commerce, to make sure that this does not happen.[136]

What combination of factors is necessary for an effective regulator is outside the scope of this essay.[137] Nevertheless, I suggest there are certain minimum requirements for an effective regulator: (1) a clearly defined

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[126] *Id.* at 13, 45 (ABS), 70 (point of sale disclosures).
[127] *Id.* at 46.
[128] *See supra* notes 67-68 and accompanying text.
[129] FRR, *supra* note 24, at 71.
[130] *Id.* at 73.
[131] *Id.* at 62.
[132] *Id.* at 72. As co-author of a recent empirical study on the securities arbitration process, I feel well-qualified to state there is no aspect of this issue that requires further study. *See* Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration,* 2 J. DISP. RESOL. 349 (2008).
[133] *See supra* note 91 and accompanying text.
[134] *See supra* note 26 and accompanying text.
[135] SEC, Concept Release Concerning Self-Regulation, 69 Fed. Reg. 71,256, 71,256 (proposed Dec. 8, 2004) (to be codified at 17 C.F.R. pt. 240).
[136] Since 1990, the financial industry has contributed $2.2 billion in political contributions; since 1998, Wall Street has been the top spender on lobbying activities. Elizabeth Williamson et al., *Finance Lobby Cut Spending As Feds Targeted Wall Street,* WALL ST. J., July 1, 2009, at A1.
[137] The question of defining effectiveness is also outside the scope of this essay.

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mission, (2) the power to effect that mission, (3) expertise, (4) resources, and finally, (5) commitment to its mission.[138] The SEC has a clearly defined mission—to protect investors.[139] The FRR seeks to address some major gaps in statutory authority, although perhaps not as cleanly as we might wish. The Agency apparently recognizes the need to improve expertise on the staff, and the Administration, at least temporarily, has committed additional resources to the Agency. So we are left with that intangible—the Agency's commitment to its mission, notwithstanding political, industry, or personal pressures to the contrary.[140]

I will conclude by telling another story about the SEC from 2008. In June 2008, the SEC proposed a rule that would subject most indexed annuities to federal securities regulation.[141] Previously, the industry had assumed that these were exclusively insurance products. In proposing the rule, the SEC noted that individuals who purchase indexed annuities (frequently, elderly investors looking for a guaranteed return) are exposed to a significant investment risk—i.e., the volatility of the underlying securities index, and that purchasers buy indexed annuity contracts for many of the same reasons that individuals purchase mutual funds and variable annuities and open brokerage accounts. Hence, the SEC concluded that federal securities regulation of indexed securities was necessary to protect investors. The SEC received about 4,800 comments on the proposed rule, principally letters from the insurance industry opposing the rule.[142] I confidently predicted at a conference I attended in fall 2008 that it would be a long time, if ever, before the SEC finalized the rule. On the contrary, someone in the audience told me, the rule would be quickly adopted. Chairman Cox's mother had purchased an indexed annuity that he thought was unsuitable for her needs, he could not resolve the situation to his satisfaction with the issuer, and he was bound and determined to get this rule passed. Indeed, in late December, the SEC approved the rule.[143] The insurance industry promptly instituted litigation to challenge the rule, asserting that the Agency exceeded its power;[144] at this time, the future of the rule remains in doubt. Whatever the outcome, the SEC must continue its responsibility to advance

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[138] S*ee* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET xviii-xxi (3d ed. 2003) (1977) (identifying these factors to assess the SEC's effectiveness).

[139] SEC mission statement: "The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." SEC, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Oct. 8, 2009).

[140] For more on this point, see Norman S. Poser, *Why the SEC Failed: Regulators Against Regulation,* 3 BROOK. J. CORP., FIN. & COMM. L. 289 (2009) (arguing that the root cause of the agency's failures was that it lost sight of its mission).

[141] Indexed Annuities and Other Certain Insurance Contracts, 73 Fed. Reg. 37,752 (proposed July 1, 2008) (codified at 17 C.F.R. pts. 230, 240).

[142] Indexed Annuities and Certain Other Insurance Contracts, 74 Fed. Reg. 3,138, 3,139 (Jan. 16, 2009) (to be codified at 17 C.F.R. pts. 230, 240).

[143] *Id.*

[144] *See* Am. Equity Inv. Life Ins. Co. v. SEC, 572 F.3d 923, 925 (D.C. Cir. 2009).

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the interests of retail investors despite concerted industry opposition.

In conclusion: SEC personnel should act as if they mean it when they say the Agency is the "investor's advocate." Think of every investor as your mother.

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